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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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MAY 31 1996

In the Matter of	)	
	)	
Allocation of Costs Associated With	)	CC Docket No. 96-112
Local Exchange Carrier Provision of	)	
Video Programming Services	)	

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COMMENTS OF COX COMMUNICATIONS, INC.

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May 31, 1996

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TABLE OF CONTENTS

		Page
	SUMMARY	i
I.	INTRODUCTION	1
II.	THE COMMISSION'S GOALS IN THIS PROCEEDING ARE CONSISTENT WITH THE 1996 ACT	3
III.	THE COMMISSION SHOULD ESTABLISH A FIXED ALLOCATION FACTOR TO NONREGULATED SERVICES FOR COMMON COSTS OF OUTSIDE PLANT USED FOR TELEPHONE AND VIDEO SERVICES.	4
	A. A Fixed Allocation Factor for Joint Use Outside Plant is Superior to the Other Allocation Methods Considered in the Notice.	4
	B. The Commission Should Require Incumbent LECs to Allocate 75 Percent of Common Costs to Nonregulated Services.	8
IV.	EXOGENOUS COST TREATMENT OF COST REALLOCATIONS IS NECESSARY FOR TELEPHONE RATEPAYERS TO BENEFIT FROM JOINT USE OF FACILITIES.	10
V.	CONCLUSION	12

SUMMARY

The Telecommunications Act of 1996 specifically requires the Commission to adopt cost allocation rules to prevent LECs from cross-subsidizing competitive services at the expense of captive telephone ratepayers. While not a new concern, the need for cost allocation rules is particularly critical as incumbent LECs continue investing in facilities necessary for them to enter the video programming market. The Commission's Part 64 rules were adopted before the provision of video and telephone services over the same facilities was technologically feasible or legally permissible and modifications must be made promptly to ensure that costs LECs are now incurring are appropriately allocated to nonregulated services.

At a minimum, the Commission must require LECs to allocate 75 percent of the common costs of facilities used for video and telephone service to nonregulated services. A 25/75 percent split of common costs between regulated and nonregulated services would be administratively simple and ensure that telephone ratepayers are not unreasonably burdened by LEC investments. This allocation would not apply to spare facilities, however, which should presumptively be allocated to nonregulated services.

The Commission also must require LECs to treat any reallocation of costs from regulated to nonregulated services as an exogenous cost for price cap purposes. Only by decreasing a LEC's price cap indices to reflect any reallocation of costs, and reducing rates for regulated telephone services accordingly, will telephone ratepayers receive some benefit from the joint use of facilities they have paid for

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COMMENTS OF COX COMMUNICATIONS, INC.

Cox Communications, Inc. ("Cox"), by its attorneys, hereby submits these comments in response to the Notice of Proposed Rulemaking (the "*Notice*") issued by the Federal Communications Commission (the "Commission") in the above-referenced proceeding.

I. INTRODUCTION

In this proceeding, the Commission proposes to reexamine its rules governing "how incumbent local exchange carriers ("LECs") allocate their costs between regulated and nonregulated activities."[1/] Specifically, the Commission states:

> The basic problem addressed in this proceeding is how to allocate common costs between the nonregulated offerings that will be introduced by incumbent local exchange carriers and the regulated services they already offer. Our current cost allocation rules were not designed for this task.[2/]

The Commission's decision to initiate this proceeding is an outgrowth of the Telecommunications Act of 1996 (the "1996 Act"), which repealed the telephone company/cable television cross-ownership prohibition and established a variety of methods for LECs to provide video service in their telephone service areas. As Cox has demonstrated

1/ *Notice* at ¶ 2.

2/ *Id.*

repeatedly over the past two years, the allocation of common costs between regulated telephone services and video services provided by incumbent LECs is one of the most critical issues facing the Commission as the telephone and cable industries converge. Cox has addressed this issue at length in various Commission proceedings regarding video dialtone and applauds the Commission's decision to face and resolve these important cost allocation questions.[3/] Cox emphasizes that this matter must be fully resolved with final rules in place before LECs begin construction of integrated telephone/video networks.[4/]

To promote the pro-competitive policies of the 1996 Act, the Commission should require LECs to allocate 75 percent of the common costs of outside plant that is used for telephone and video services to nonregulated services. The Commission also should ensure that existing LEC interstate price caps are adjusted so that telephone ratepayers indirectly receive some benefit from the joint use of facilities and any corresponding reallocation of costs from regulated to nonregulated services. As incumbent LECs continue massive

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3/ *See, e.g., Bell Atlantic Telephone Cos. (Revisions to Tariff F.C.C. No. 10)*, Transmittal Nos. 741, 786, CC Docket No. 95-145 ("*Dover Video Dialtone Investigation*"), Opposition to Bell Atlantic Direct Case, filed by Cox Enterprises, Inc. (Nov. 30, 1995); *Price Cap Performance Review for Local Exchange Carriers; Treatment of Video Dialtone Services Under Price Cap Regulation*, CC Docket No. 94-1, Petition for Reconsideration, filed by Cox Enterprises, Inc. (Nov. 6, 1995).

4/ One method by which LECs can provide video programming is through an "open video system." As Cox stated in its comments in the Commission's rulemaking to implement the OVS provisions of the 1996 Act, under no circumstances should LECs be permitted to file OVS certifications *before* the Commission adopts cost allocation requirements in this proceeding. LECs also must be required to file amendments to their Cost Allocation Manuals before filing OVS certifications.

spending to support their entry into the video services market, prompt adoption of cost allocation rules will help provide some protection for captive telephone ratepayers from inappropriate or illegal cross-subsidy.

II. THE COMMISSION'S GOALS IN THIS PROCEEDING ARE CONSISTENT WITH THE 1996 ACT.

In the *Notice*, the Commission established three basic goals for this proceeding: (1) to facilitate the development of competitive telecommunications offerings; (2) to facilitate LEC entry into the video distribution and programming services market; and (3) to ensure that telephone rates are just and reasonable. *Notice* at ¶ 22 These three goals correctly recognize that Congress sought to promote competition for all services, but not at the expense of captive telephone ratepayers. Indeed, the joint use of facilities for telephone and video services should produce economies that would not exist if the services were provided over separate facilities. Because customers of regulated services have paid for existing LEC networks, the Commission correctly concludes that "telephone ratepayers are entitled to at least some of the benefit of the economy of scope between telephone and competitive services."[5/]

To achieve these goals, the Commission hopes to establish cost allocation principles that are administratively simple, adaptable to evolving technologies, capable of uniform application among incumbent LECs and consistent with economic principles of cost

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5/ *Id.* at ¶ 23. To take a simple example, if a stand-alone telephone network costs $10 million, a stand-alone cable facility costs $10 million and an integrated facility costs $15 million, customers of telephone services should receive a portion of the $5 million saved by using integrated facilities (*i.e.* some amount less than the $10 million stand-alone cost of a telephone network should be allocated to regulated telephone service).

causation. *Notice* at ¶ 24. The Commission correctly has recognized that cost allocation rules that are difficult to apply, capable of manipulation or that yield unpredictable results will facilitate anticompetitive conduct by incumbent LECs and hinder the development of competitive markets.

As described in the following sections, the best ways to achieve the goals established by the Commission and Congress are to: (1) establish a fixed allocation factor for allocating the historic and prospective common costs of joint use outside plant to nonregulated services; and (2) require exogenous cost treatment for any cost changes that result from a reallocation of costs from regulated to nonregulated services. By adopting these policies, the Commission can reduce the risk of anticompetitive cross-subsidization and promote the development of fair competition in all telecommunications markets.

III. THE COMMISSION SHOULD ESTABLISH A FIXED ALLOCATION FACTOR TO NONREGULATED SERVICES FOR COMMON COSTS OF OUTSIDE PLANT USED FOR TELEPHONE AND VIDEO SERVICES.

A. A Fixed Allocation Factor for Joint Use Outside Plant is Superior to the Other Allocation Methods Considered in the Notice.

The Commission correctly recognizes that allocating the costs of joint use of outside plant, particularly loop facilities, is the single most important issue in this proceeding. *Notice* at ¶ 2. Loop costs presently are directly assigned to regulated services because the deployed loops are used nearly exclusively to provide regulated telephone services.[6/] Under the existing Part 64 rules, when direct assignment of outside plant costs is not possible, costs

6/ While LECs also deliver nonregulated enhanced services such as voice mail or caller ID over local loops, the Commission historically has relied upon Part 64 relative use cost allocation procedures for the LEC to assign these relatively minor nonregulated costs.

are allocated based on the relative regulated and nonregulated use during a forecasted three-year period. 47 C.F.R. § 64.901(b)(4). However, as LECs begin to provide new capital intensive services, such as video programming, over loop facilities that also are used for regulated telephone services, application of the current Part 64 rules could create inappropriate assignment of LEC costs from regulated to nonregulated use.[7/] Accordingly, the Commission tentatively concludes that the current usage-based allocation, which is predicated on a LEC's three year forecast of relative use, must be revised in a manner consistent with the goals of the 1996 Act: to introduce fair competition and prevent cross-subsidization of competitive services.[8/]

7/ Cox has expressed concern for some time about the ability of incumbent LECs to manipulate cost data even within the Part 64 framework. This concern motivated Cox to propose a 50/50 cost allocation prior to the Part 64 process. *See* Letter to William F. Caton, Acting Secretary, Federal Communications Commission, from Laura H. Phillips, Counsel for Cox Enterprises, Inc., CC Docket No. 87-266 (filed July 12, 1995), attached as Exhibit A. Cox recognizes the Commission's reluctance to abandon the Part 64 direct assignment process. Cox believes, however, that because of the *Notice's* expressed intent to apply a fixed allocation only to common costs, an adjustment to Cox's previous proposal of 50/50 is appropriate and should be required.

8/ 47 U.S.C. § 254(k) ("A telecommunications carrier may not use services that are not competitive to subsidize services that are subject to competition.") The *Notice* also asks whether its tentative conclusion to allocate loop costs based on a fixed factor is equally applicable to interoffice trunks. Because direct assignment is equally difficult in both cases, the benefits of the fixed factor approach are the same. Accordingly, the Commission should require that interoffice transmission facilities be subject to the same cost allocation procedures as loops.

The decision to prescribe a fixed allocation factor for the cost of loops used to provide regulated and nonregulated services is a sound one. Past Commission experience with video dialtone Section 214 authorizations and tariffs demonstrates that there are numerous ways to allocate common costs and each will have an impact on the costs to be borne by captive telephone ratepayers and, absent changes in the Commission's Part 36 rules, on the costs passed on to the states under the jurisdictional separations process. As recognized by the Commission, a fixed factor would be simpler to apply than a usage-based factor and easily can be applied uniformly among incumbent LECs. *Notice* at ¶ 42. Furthermore, a fixed factor will produce results that are more consistent with cost causation principles than a usage-based approach because the usage characteristics of video and other high capacity services are significantly different than voice grade telephone services.[9] Prescribing a fixed factor for outside plant also ensures that cost allocations cannot be easily manipulated to shift additional costs to telephone ratepayers, a result which would be patently at odds with the 1996 Act.

As Cox has stated previously, a fixed factor also has the benefit of applying the same allocation to a LEC's investment in joint use facilities regardless of the regulatory model under which the LEC provides video service. In addition, because the fixed factor would be applied before the Part 36 separations process, states would not be forced to scrutinize LEC cost allocations to ensure that a reasonable portion of common costs are assigned to competitive services.

9/ *Notice* at ¶¶ 30-31. As the Commission recognizes, given an equal number of video and telephone communications, video transmissions likely will account for the great majority of minutes of use and information transmitted.

As recognized by the Commission, a fixed allocation factor in the case of outside plant is far superior to an allocation based on the ratio of directly assigned investment. *Notice* at ¶ 34. While the Commission's cost allocation rules contain a general allocator based on the ratio of directly assigned costs, 47 C.F.R. § 64.901(b)(iii), the Commission adopted this rule based on its expectation that 80-90 percent of costs would be allocated on a cost causative basis, rather than with the general allocator.[10/] In the case of outside plant jointly used for video and telephone services, the Commission already has recognized that such a small portion is capable of direct assignment that using the ratio of directly assigned costs as an allocation factor is an invitation for LECs to manipulate their network architectures so as to minimize or even avoid allocating costs to nonregulated services.[11/] Accordingly, there is no reasonable basis for using the ratio of directly assigned plant as a general allocation factor.

The *Notice* also considers the question of whether a ceiling should be established on the total loop costs that LECs may allocate to regulated activities based on the costs of the current telephone system. This concept is fraught with complexity. Based on information several LECs presented in their video dialtone Section 214 applications, LECs already have constructed and installed huge amounts of "spare" fiber in their networks. Whether these network investments (that may well be used for nonregulated services) are properly part of a

10/ *See Separation of Cost of Regulated Telephone Service from Costs of Nonregulated Activities*, Report and Order, 2 FCC Rcd 1298, 1318 n. 280 (1987).

11/ *See Dover Video Dialtone Investigation*, Order, 10 FCC Rcd 10831, 10841 (rel. June 9, 1995) (An allocation that depends on "the presence of, and pricing for, relatively few pieces of equipment in one integrated system" requires investigation).

ceiling would be a difficult and contentious issue to resolve. Moreover, establishing a ceiling at the current level of loop costs could deny telephone ratepayers the benefits of integrated use of the facilities. Accordingly, the cost ceiling allocation methodology fails to meet the Commission's enunciated goal of simplicity.

B. The Commission Should Require Incumbent LECs to Allocate 75 Percent of Common Costs to Nonregulated Services.

The Commission tentatively concludes that a fixed allocation factor should be applied to outside plant that is used for both regulated and nonregulated service, but it reaches no conclusion as to what factor should be used or how it should be determined. Based on the Notice's proposal, the fairest and simplest approach for allocating the costs of LEC network facilities used to provide video services and regulated telephone service is to require 75 percent of common costs to be allocated to nonregulated services.[12/]

This allocation proposal meets all the requirements enunciated by the Commission as desirable for cost allocation procedures. The 75/25 approach is administratively simple, technology neutral and easily can be applied to all incumbent LECs. A fixed allocation of common costs between regulated and nonregulated services recognizes that cost allocation is a policy decision and avoids the need to determine in an ad hoc fashion the "right" allocator.

12/ *See* Exhibit A. Cox's original proposal called for a 50/50 split of total network upgrade costs between telephone and video services, with each portion then subjected to Part 64 cost allocations and Part 36 jurisdictional separations. This proposal reflected the fact that video dialtone was a regulated Title II video service and that Part 64 alone would not prevent cross-subsidy between video dialtone and regulated telephone services. Because the video programming options available to LECs under the 1996 Act are not Title II regulated services, modification of Part 64 to require 75 percent of common costs to be allocated to nonregulated services should achieve the same goals as Cox's original proposal.

The Cox approach is a reasonable compromise between the Commission's desire to adopt rules that promote LEC infrastructure investment and Congress' mandate that the Commission protect telephone ratepayers from cost manipulation that would cause them to bear an unreasonable portion of the costs of LEC network rebuilds. The Commission notes, however, that telephone ratepayers not only should be protected from cross-subsidy, but they also should share the benefit of any joint use of facilities that previously were devoted to telephone services. In this regard, an allocation of 75 percent of common costs to nonregulated services must be viewed as the minimum that is required. The Commission should not hesitate to require a higher allocation to nonregulated services if necessary to give telephone ratepayers a fair share of any efficiency gains through the joint use of facilities.

The *Notice* also raises the question of whether the current usage-based allocation for spare facilities is appropriate given LEC investment in broadband facilities that will be used to provide video programming and other high capacity services. *Notice* at ¶ 51. The Commission notes that telecommunications networks are evolving, with fiber cables being deployed closer to subscribers' premises. At the same time, however, the relative magnitude of spare facilities is increasing and, in some cases, is greater than the capacity of working facilities. For example, the Commission observes that for the years 1991 through 1994, anywhere from 63 to 70 percent of LEC deployed fiber was spare fiber. Obviously the growing amount of spare outside plant capacity provides LECs ample opportunity, without adequate Commission guidance, to overallocate facility costs to regulated ratepayers.

In allocating the costs of spare facilities, the Commission correctly concludes that "Congress did not intend that telephone exchange service or exchange access subscribers pay rates designed to recover the costs of spare capacity that eventually will be used for video programming and other services that may be competitive." *Notice* at ¶ 53. Because incumbent LECs soon will face competition for telephone services, in the future they may be carrying *less* traffic than they do today and any spare capacity in their networks will be for nonregulated services. Thus, while a 75/25 allocation is appropriate for plant that is in use, spare facilities presumptively should be allocated to nonregulated services.

IV. EXOGENOUS COST TREATMENT OF COST REALLOCATIONS IS NECESSARY FOR TELEPHONE RATEPAYERS TO BENEFIT FROM JOINT USE OF FACILITIES.

The Commission's price cap rules specify that cost changes caused by the reallocation of investment from regulated to nonregulated activities pursuant to the Part 64 cost allocation rules are considered exogenous cost changes. *Notice* at ¶ 60. The Commission asks whether all reallocations to nonregulated activities resulting from rule changes in this proceeding should trigger decreases in price cap indices. *Id.*

Exogenous cost treatment for cost reallocations and a corresponding decrease in interstate price cap indices advances the Commission's goal of ensuring that telephone ratepayers receive some benefit from the joint use of facilities that now are used almost exclusively for regulated telephone service. These facilities have been paid for by customers of regulated services and any use of these facilities for nonregulated services must be compensated through prospective rate reductions.[13/] Any failure to adjust a LEC's price cap

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13/ The same is true for certain categories of expenses, such as research and development. LECs have spent a tremendous amount of money preparing for their entry into the video market and the lion's share of these costs already have been assigned to regulated (continued...)

indices to reflect a reallocation of costs to nonregulated services would be tantamount to a direct cross-subsidy at the expense of the LEC's telephone customers.

The *Notice* also asks whether Part 64 processes are necessary for price cap LECs that are not subject to a sharing obligation. *Notice* at ¶ 62. As Cox has demonstrated previously, the existing price cap regime for incumbent LECs does not eliminate the LECs' incentive or ability to cross-subsidize competitive services.[14] A LEC's reported costs still are critical to the calculation of its productivity and the determination of whether its earnings trigger a sharing obligation. By shifting costs from nonregulated to regulated services, a LEC can lower its productivity, resulting in a reduced productivity factor in future years.

Moreover, under the current price cap regime carriers may decide annually what productivity factor to use and whether to participate in sharing. Even if a LEC elects a no-sharing option, it still has an incentive to systematically misallocate costs to regulated services, thereby reducing regulated earnings and avoiding future sharing obligations. Thus, cost allocation remains relevant for all price cap LECs regardless of whether they have

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13/ (...continued)
telephone services. In the video dialtone context, for example, Bell Atlantic stated that it has spent only $38.74 on research and development for its Dover, New Jersey video dialtone system. *See Dover Video Dialtone Investigation*, Cox Opposition to Bell Atlantic Direct Case at 19 n.45. Given that the Dover facility was the first LEC video facility to employ all-digital technology, this low allocation of research and development costs demonstrates that the current cost allocation system has resulted in potentially vast inappropriate allocations to regulated telephone services.

14/ *See, e.g.*, Letter from James O. Robbins, President and Chief Executive Officer, Cox Communications, Inc., to Reed E. Hundt, Chairman, Federal Communications Commission (June 28, 1995), attached as Exhibit B.

elected sharing for the current year.[15/] Indeed, as long as any regulator reviews an incumbent LEC's cost information for any purpose (*e.g.*, universal service) the allocation of costs between regulated and nonregulated services remains an important issue.

V. CONCLUSION

Cox strongly supports the Commission's tentative conclusions in this proceeding that revised cost allocation rules are required for LEC investments in video facilities. Cox urges the Commission to expeditiously prescribe a fixed allocation factor of 75 percent to nonregulated services for the common costs of outside plant and to require exogenous cost treatment of reallocations from regulated to nonregulated services. As part of its cost allocation policy, the Commission also must examine how incumbent LECs have treated spare capacity and research and development costs related to their entry into the video market and adopt policies that require LECs to reallocate these costs to protect ratepayers.

15/ Moreover, regardless of the pricing rules employed by state and federal regulators, Section 220(a)(2) of the Communications Act specifically requires the Commission to have in place procedures for allocating costs between services.

By adopting these policies, the Commission can promote the pro-competitive policies underlying the 1996 Act, while protecting telephone ratepayers as required by Congress in the 1996 Act.

Respectfully submitted,

COX COMMUNICATIONS, INC.

Laura Phillips

Werner K. Hartenberger
Laura H. Phillips

Its Attorneys

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May 31, 1996

Exhibit A

Letter from Laura H. Phillips on behalf of Cox Enterprises, Inc.
to William F. Caton, Federal Communications Commission

CC Docket No. 87-266
July 12, 1995

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July 12, 1995

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OFFICE OF THE SECRETARY

VIA MESSENGER
Mr. William F. Caton
Secretary
Federal Communications Commission
1919 M Street
Washington, D.C. 20554

EX PARTE

Re: CC Docket No. 87-266

Dear Mr. Caton:

On Tuesday, July 11, Alexandra Wilson and Alexander Netchvolodoff of Cox Enterprises, Inc. met with Richard Welch, Legal Advisor to Commissioner Chong, to discuss the Commission's Fourth Further Notice of Proposed Rulemaking in the above-referenced docket. A copy of the handout distributed during the meeting is attached. This letter was not filed until today due to the late time of the meeting.

Please contact the undersigned should you have any questions with regard to this filing.

Sincerely,

Laura Phillips

Laura H. Phillips

cc: Richard Welch

COX POSITION ON FOURTH FURTHER NOTICE IN VIDEO DIALTONE RULEMAKING PROCEEDING

- The Commission created the concept of video dialtone in response to the statutory prohibition that prevents telcos from providing video programming directly to subscribers over their own networks. Now that the courts have declared the statutory ban unconstitutional, telcos are free to offer video programming over their networks as Title VI cable operators (subject to appropriate safeguards), and all of the goals articulated by the Commission in establishing video dialtone have been met. Accordingly, Cox believes that there no longer is a need for video dialtone.

- If the Commission nonetheless determines that sound policy reasons for video dialtone continue to exist, it must clearly articulate (a) what those policy reasons are, (b) why those objectives cannot be met through operation of Title VI cable systems, and (c) how video dialtone is different from traditional cable service. The Commission also must make it clear that anyone (including cable operators) can elect to provide video dialtone; VDT must not be declared the exclusive province of the telcos.

- The Communications Act unequivocally states that a telco that offers programming directly to subscribers over its own network is a "cable operator" providing "cable service" over a "cable system" pursuant to Title VI. As the legislative history demonstrates, moreover, Title VI applies to both the programming service and the underlying facilities used to provide the programming service. The only portion of a telco video network that conceivably could be considered a Title II common carrier service is that portion of the network (if any) offered on a common carrier basis to unaffiliated programmers.

- Assuming the Commission offers telcos (and cable operators) who offer programming on their networks the option of providing video common carriage in addition to cable service, the Commission should ensure that its rules do not create an artificial regulatory incentive to opt for one business model over the other. The decision whether to offer a common carrier platform to unaffiliated programmers should be based on business considerations which reflect the real interests of consumers. It should not be reached because policy makers have decided to implement an industrial policy that pushes (through artificial accounting or other regulatory incentives) the owners of video networks toward video common carriage, even when the business case does not support such a result.

- The most important thing the Commission can do to ensure that its regulations are neutral with respect to selecting a business model is to make it clear that telcos who choose to offer video programming over their own networks will not be entitled to put a greater burden on telephone ratepayers if they opt to provide a common carrier platform in addition to cable service than if they elect to provide cable service alone. This means that the FCC rules used to allocate the costs of an integrated broadband facility between telephony and video services should not be more favorable if video common carriage is offered than if it is not. After all, the key goal of cost allocation is to guarantee that telephone ratepayers do not foot the bill for an upgrade that is undertaken principally to add video capabilities. Clearly, the portion of the upgrade costs that those ratepayers are required to bear should not depend on whether some of the video services carried over the network happen to be offered under Title II while others are offered under Title VI.

- The Commission could achieve the desired result of cost allocation neutrality by adopting a few very simple rules:

    1. Telcos would be allowed to allocate to the telephone ratebase a maximum of 50 percent of the costs of any future telco upgrade. (This is an extremely generous allocation of costs for the telcos, since the real reason they are upgrading their networks is to provide video and other broadband services, not to add new narrowband services.) The remaining 50 percent of the upgrade costs would be allocated to video and other broadband services (whether regulated or unregulated).
    2. The 50 percent of the upgrade costs allocated to video/broadband services in turn would be assigned among regulated and unregulated video/broadband services using Part 64 of the FCC's rules. The portion of costs assigned to regulated video/broadband services (such as video common carriage) would then be subjected to the traditional Parts 36[1] and 69 analysis in order to establish just and reasonable tariff rates for the regulated services. A schematic diagram of the proposal is attached.

- This approach would be simple to administer, would protect telephone ratepayers from shouldering an undue portion of the costs of a broadband upgrade, and would avoid many of the subjective judgment calls that are inherent in a more traditional Title II analysis. It also would treat all facilities-based video programmers equally and ensure that one video network did not have an unfair regulatory advantage over another.

[1] Cox urges the Commission to initiate promptly its promised proceeding to modify the Part 36 jurisdictional separations rules to accommodate video common carriage services.

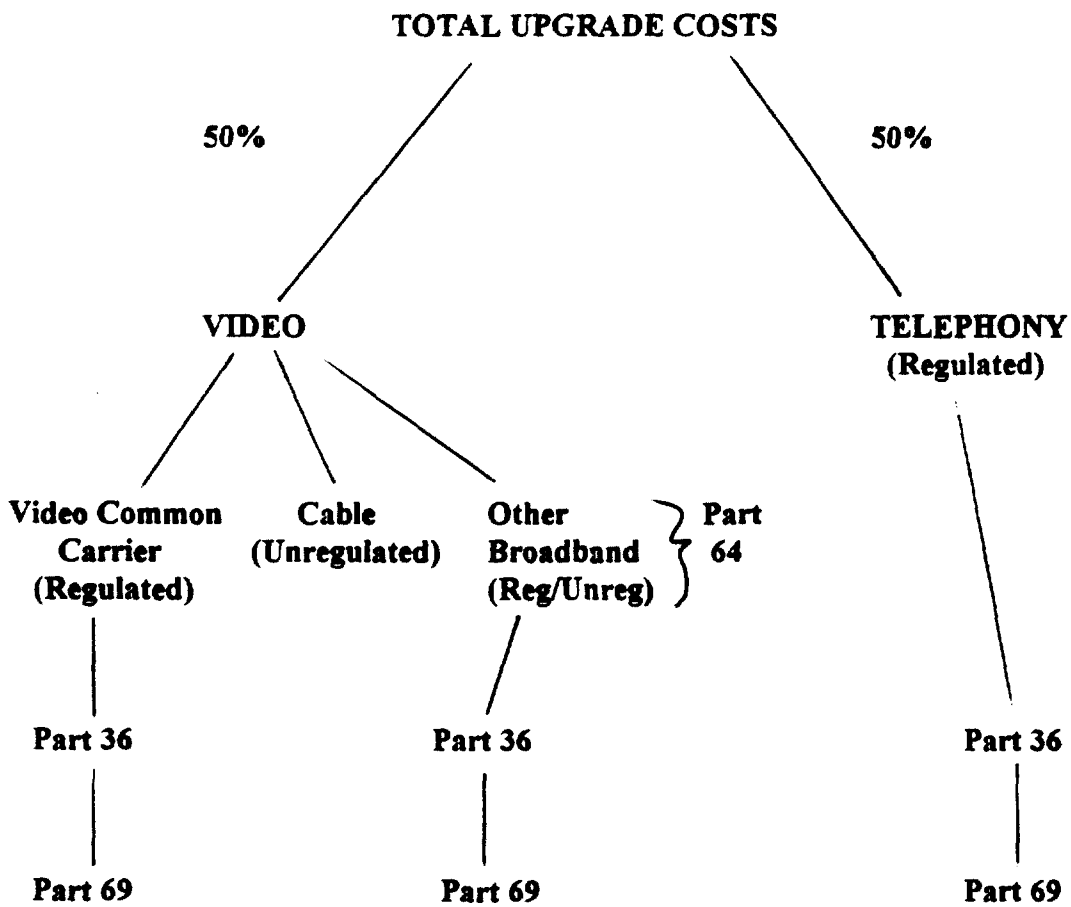
TOTAL UPGRADE COSTS
50%
50%
VIDEO
TELEPHONY
(Regulated)
Video Common Carrier (Regulated)
Cable (Unregulated)
Other Broadband (Reg/Unreg)
Part 64
Part 36
Part 36
Part 36
Part 69
Part 69
Part 69

Exhibit B

Letter from James O. Robbins, Cox Communications, Inc.
to Reed E. Hundt, Federal Communications Commission

June 28, 1995

James O. Robbins
President and Chief Executive Officer

Cox Communications, Inc.
1400 Lake Hearn Drive NE
Atlanta, Georgia 30319
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June 28, 1995

COX COMMUNICATIONS

The Honorable Reed E. Hundt
Chairman
Federal Communications Commission
1919 M Street, NW, Room 814
Washington, D. C. 20554

Dear Mr. Chairman:

Much is made about an assertion that price cap regulation of LECs eliminates their incentive to cross subsidize new services from their monopoly rate base. Flowing from this assertion, it is argued that there is no need for the FCC to impose reasonable cost allocations between telephony and video dialtone services because price caps eliminate cross-subsidies.

Enclosed is a white paper by Snavely King and Associates which debunks this assertion whether it is based on: (1) the FCC's existing price cap regime; or (2) a theoretically reformed FCC "pure" price cap regime in which sharing options are eliminated.

First, the FCC's existing price cap regime permits LECs to game the system by moving from high price caps with no sharing to lower price caps with sharing as their anticipated revenues and future sharing obligations dictate. If LECs misallocate costs to telephony, thereby artificially depressing telephony earnings, virtually all of the productivity benefit from the price cap is lost. In other words, under the existing Commission's price cap regime, the LECs have every incentive to transfer virtually all of the costs of VDT to their captive rate base.

Second, even if the Commission reforms its existing price cap regime to eliminate the sharing options, some adverse effects of cross-subsidy from improper cost allocation will remain because the misallocation of common costs to telephony always will deflate the productivity factor and offset the expected decline in regulated telephone costs to consumers.

Third, under existing jurisdictional separations rules, state regulators face 75% of the consequences of cost misallocation to telephony without any remedy under the VDT tariff process. Moreover, many state regulators face changes in state law which, under reform of state price caps, forbid the collection of cost and revenue data needed to address the local VDT cross-subsidy issues.

Cost accounting without cost allocation is like Yin without Yang. The responsibility to confront and decide this fundamental public policy issue quite simply cannot be avoided by claiming price caps prevent cross-subsidy since, as our analysis shows, they do not. In light of this reality, the Commission should immediately take several concrete steps to protect telephone ratepayers: (1) revise Part 64 and 36 accounting rules to separate all video dialtone costs from telephone costs prior to the jurisdictional separation process; (2) determine a reasonable allocation of common costs that must be applied in all VDT tariffs; and (3) impose procedures that exclude VDT from price caps and from all price cap productivity factor calculations.

Sincerely,

Jim Robbins

Enclosure

cc: The Honorable James H. Quello
The Honorable Andrew C. Barrett
The Honorable Rachelle B. Chong
The Honorable Susan Ness

Effect of Video Dialtone Cross-Subsidies on Price Cap Carriers

Report by
Snavely, King & Associates, Inc.
to Cox Enterprises, Inc.

The video dialtone systems proposed by a number of Local Exchange Carriers ("LECs") are not profitable. In LEC filings, common video/telephony costs and corporate overhead costs are underassigned to video dial tone. As these video dialtone systems are built, they will be financed and sustained by heavy cross-subsidies from telephony operations.

The argument has been made that cross-subsidies are of no consequence to ratepayers of monopoly telephone services because the "price cap" scheme adopted by the Federal Communications Commission ("FCC") insulates consumers from the effects of misallocations. Telephone ratepayers, it is argued, are protected from any effects of overstated costs, including cross-subsidies of video dialtone services, because the LEC's actual costs and productivity are not used in the formula for updating the price cap. The formula simply subtracts the productivity option chosen by the LEC from the inflation rate (see Figure 1 attached for options).

The way this consumer insulation is supposed to work is illustrated by Figure 2. A carrier electing the "pure" price cap option (i.e. no requirement to share profits above a certain amount with ratepayers) must *offset* inflation by an annual productivity